‘5 Conduct Questions’
Industry Feedback for 2016
Wholesale Banking Supervision

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Introduction

Conduct risk is one of the largest contingent risks that any wholesale bank has on its balance sheet. By its very nature, this risk cannot be sold, very rarely matures and cannot be hedged using normal market instruments. Any other risk on a bank's balance sheet with this risk profile, would, understandably, be managed and scrutinised to a very heavy degree. We therefore expect firms to place equally heavy scrutiny over (and controls around) conduct.

Efforts to understand a firm's culture and the norms and beliefs (coming from both within and outside the organisation) that drive staff behaviour are extremely important to improving conduct. This is why efforts to understand and improve the culture of firms are also woven into the 5 Conduct Questions.

Assessing firms' progress

These 5 Conduct Questions are part of the FCA's strategy for supervising wholesale banks. In 2016 we introduced Annual Conduct Meetings (ACMs) for the largest firms to help us understand:

- how they have considered the 5 Conduct Questions, and
- what measures they're taking to improve conduct in their firms.

The focus for the first round of meetings was on Question 1 (identifying conduct risks), but we also wanted to understand how firms are approaching the other four questions. This work connects to the broader FCA priority on culture and governance set out in our 2016/2017 Business Plan.

Recognising that no particular approach is 'right', this update provides a summary of what firms have told us about conduct risk and highlights some of the actions firms have taken that they believe have been effective.

While our ACM programme focuses on larger firms, the feedback is also relevant for smaller wholesale banking firms.

We encourage all wholesale banking firms to read the feedback and consider if any of the approaches may be effective in their own organisations.

The 5 Conduct Questions:

1. What proactive steps do you take as a firm to identify the conduct risks inherent within your business?
2. How do you encourage the individuals who work in front, middle, back office, control and support functions to feel and be responsible for managing the conduct of their business?
3. What support (broadly defined) does the firm put in place to enable those who work for it to improve the conduct of their business or function?
4. How does the Board and ExCo (or appropriate senior management) gain oversight of the conduct of business within their organisation and, equally importantly, how does the Board or ExCo consider the conduct implications of the strategic decisions that they make?
5. Has the firm assessed whether there are any other activities that it undertakes that could undermine strategies put in place to improve conduct?

Summary

Across the industry:

- significant progress has been made in identifying and managing conduct risk
- firms believe that maintaining a reputation for the highest standards of conduct benefits their business
- some initially UK-centric conduct and culture programmes are now being applied internationally
- frontline business areas are taking greater ownership for conduct risk
- firms should be aware that conduct risk may arise across the whole organisation and not just in the frontline business areas

While progress is encouraging, it is too early to determine how effective these conduct risk programmes are, or will be, in the longer term.

We encourage firms and senior management to continue to focus on their programmes and on embedding them throughout their organisations.

Next steps for the FCA

We will continue to hold ACMs with the large firms and will next focus on Question 2:

'How do you encourage the individuals who work in front, middle, back office, control and support functions to feel and be responsible for managing the conduct of their business?'

This question is particularly relevant given the SM&CR and the future extension of the regime to all FSMA-authorised firms.

As well as the other four questions, we will also consider the impact technology can have on conduct risk. While technology can provide firms with sophisticated monitoring and detection mechanisms, technological advances can also pose new and different conduct risks for firms to manage.

Design of Conduct Risk Change Programmes

Firms have been clear that the design features of their individual programmes are key to how rapidly they can be implemented and perhaps ultimately how effective they will be in changing practices and behaviours. Here we outline the features of programmes which firms recognised as being more – as well as less – effective.

More effective programmes

Conduct risk programmes should be tailored to the needs of each firm based on its size, business model and geographic reach. While there is no single 'correct' answer, the following features are generally recognised by firms as being effective:

- highly visible CEO sponsorship together with engagement and challenge by the Board
- senior executives taking leading roles in programme design
- programmes that cover both front office, control and operational functions
- detailed roll-out plans with clearly defined short-term and long-term goals
- clear ownership and responsibility for implementing programmes by senior executives, sometimes supported by conduct specialists within the organisation
- programmes that are integrated within strategic or operational risk management frameworks
- use of a standardised conduct risk self-assessment process across the firm
- a firm-wide taxonomy for conduct risk types, enabling consistent data capture and risk reporting
- a forum to compare conduct risk across business lines and functions
- regular discussion at Board level of conduct, culture and programme-implementation
- active engagement in the programme by internal audit, including monitoring how effective the programme is at an early stage
- training, promotion, performance management and remuneration all linked to conduct and culture objectives
- long-term conduct risk initiatives becoming fully embedded in business-as-usual
- for international firms, that the head office adopts or at least supports the UK programmes

Less effective programmes

Firms evidenced that Programmes with the following features generated less-favourable results:

- one-off or stand-alone projects with a short timeframe
- the Compliance function or the COO being the primary driver of the programme
- teams are asked to identify risks against a narrow range of set principles, when teams should be capturing a much broader list of all their risks.
- disjointed or uncoordinated efforts by different business units
- excluding significant business units, control or operational functions
- not examining if conduct risk in one area could arise in another
- limiting programme focus to front office senior personnel, with little or no involvement from middle and back office, risk, control and other support functions

Question 1:
'What proactive steps do you take as a firm to identify the conduct risks inherent within your business?'

Defining conduct risk

Most firms consider defining 'conduct risk' an essential first step.

Definitions typically refer to client outcomes and some also include factors such as business sustainability and market integrity. Other elements include the danger of actions or behaviours, or the conduct of business, that may:

- harm clients
- cause the firm reputational damage
- risk undermining the integrity of the financial markets

Some definitions also refer to the FCA's competition objective, namely, 'to promote effective competition in the interest of consumers'.

Identifying conduct risk

Firms described 3 main approaches to identifying conduct risk:

1. A top-down model where centrally defined key risks were mapped to business activity, products and processes.
2. A bottom-up model where individual business units analysed their own business and processes end-to-end. This identified risks, often at the desk level, that were then aggregated.
3. A reverse-engineered approach. Here, the firm reviews its processes to identify threats to desired firm-level principles or conduct outcomes and then designs controls that could mitigate the risks to these desired outcomes.

Most firms used a combination of approaches 1 and 2. Only a few firms used the 3rd approach and some of these subsequently supplemented this with approach 2.

Most firms preferred approaches that are designed in-house. However, some firms used external consultants, often to start the process or provide a peer perspective.

Approaches to collaboration

Firms took different approaches to collaboration and challenge in the risk identification process.

We saw examples where the business alone would identify a set of risks before the 2nd line challenged the result. We saw other examples where the business and the wider 2nd line would work together to identify the risks.

We saw some cases where work to identify risks was driven primarily by control functions such as Compliance. These cases tended to make less progress or had to be repeated to be effective, compared to firms who used a business-led approach.

Level of detail used

Firms also used different levels of detail in their risk identification process. Some firms used a desk-by-desk level, involving the individual desk heads and front office. Others combined groups of desks, businesses or products.

Some firms held sessions led by senior business line staff where conduct risks and 'grey' areas or 'dilemmas' were discussed. Firms used these sessions to discuss difficult issues and reinforce expectations, uncover additional conduct risks and produce FAQs for all their staff.

Firms found these sessions were useful for both raising awareness of risks and identifying them. As a result, the risk identification process itself also became a training session and also highlighted the importance of escalating issues promptly.

Most firms initially focused their identification effort on front office - and especially client-facing - activity. Conduct risks can also occur across both operational and control functions, but firms have generally made less progress identifying conduct risks outside of specific business lines. There is increasing awareness that, to be effective, risk assessments based on front-to-back process mapping need coordination with all the necessary support functions.

Firms are at various stages of embedding their approaches to identifying conduct risk. More advanced firms now have a process that has been in place for several years.

We have also seen an increasing number of firms considering how they can map their conduct risk frameworks into their Enterprise Wide Risk Management Frameworks under their Chief Risk Officers.

Business leadership of the programme

Most firms emphasised the importance of Executive Committee leaders, and business heads generally, being prominently involved and actively supporting the programme's status and visibility within the organisation.

Cross-comparison of risks

Risks identified in one business may occur, perhaps in a slightly different form, in other businesses.

Some firms have highlighted the benefit of performing 'read-across' exercises around conduct risk incidents and comparing the conduct risks identified. The FCA has consistently stated the value of considering the applicability of risks and issues from one area to other business areas. This should be seen as good risk identification rather than an isolated exercise of 'read across'.

One example we saw is a monthly 'Conflicts Academy' where cross-firm conflict issues are raised and case studies examined, with subject matter experts available to give guidance.

Another example is where a firm has established a Lessons Learned Team, which undertakes reviews to determine root causes and proactively apply the lessons learned to other businesses. Another firm highlighted the individual responsibility business heads have under the Senior Managers & Certification Regime (SMCR). This firm allowed business heads more discretion in how they identify their conduct risks in the early stages but planned for more cross-comparison work in the future.

Question 2:
'How do you encourage the individuals who work in front, middle, back office, control and support functions to feel and be responsible for managing the conduct of their business?'

Adherence cannot be legislated and staff cannot be left to guess at what senior management wants them to do in particular circumstances. Firms must take clear steps to communicate in a clear manner.

Findings:

- Many firms believe that the 'tone from the top' is also key here. They use techniques such as senior management cascades, webcasts and 'town hall' meetings to profile the firm's values, characteristics and expectations of staff around treatment of customers, and behaviour in markets.
- Many firms make good conduct and a culture supporting good conduct an explicit line of business priority.
- We saw firms using all-staff video messages from their CEO to underline the importance of maintaining good conduct and appropriate culture. This was supported by poster campaigns, screensavers etc to emphasise the message.
- One firm had a 'Conduct Week' with a wide range of events – others had similar programmes to raise awareness.
- Some firms have created videos with staff and/or clients highlighting the behaviors they expect from staff.
- When conduct incidents happen, firms also consider the role of senior staff, supervisors, control functions, and bystanders who did not speak up.
- Many firms have conduct policies and some firms require supervisors to attest that they have fulfilled their roles as supervisors.
- Firms also have firm-wide Codes of Conduct, which may require confirmations from relevant staff members on an annual basis. Several have recently re-launched their codes.
- Some firms have different codes of conduct for supervisors, recognising their specific responsibilities.
- Firms are emphasising to staff that taking individual responsibility for their own conduct and that of their direct reports has been reinforced by the introduction of the Senior Managers and Certification Regime.

- Management reinforces personal ownership of conduct risks by way of a direct connection to individual objectives, remuneration, recruitment and promotion processes.
- One firm holds a periodic challenge process between the head of the business and the Board on how all risks, including conduct risk, are managed.
- One firm sent some of their staff to the Old Bailey to watch part of a LIBOR trial.
- Some firms use actual examples of inappropriate staff behaviour and email traffic to encourage all staff to set the right example.

Question 3:
'What support (broadly defined) does the firm put in place to enable those who work for it to improve the conduct of their business or function?'

We found that support can take many forms as outlined below.

Findings:
Supervision, procedures and management information

- One firm identified that supervisors had missed a number of trading incidents but also did not have the correct information to help them identify them. So the firm focused on ensuring the supervisors had accurate information.

- One firm used their own staff to try to 'ethically' hack their own systems and controls as they were rolling out upgrades to ensure they were genuinely effective.

- Most firms showed that they have developed conduct risk Management Information (MI) at desk-head level, produced centrally, with a set of metrics about individuals' conduct and policy breaches. These dashboards pick up an extensive range of factors, including:

missed or late training	customer complaint analysis
PA dealing breaches	most profitable trades
excessive hours worked	expensive client entertainment
lateness for work	clients earning the firm the most money
limit breaches	compliance exceptions
late trades	suspicious transaction reports
expense policy breaches	Selected HR reports

- The intention is to bring together disparate pieces of information to give supervisors a clearer picture of the risk and compliance culture of their area so they can manage it more effectively.

- Some firms have progressed to having risk tolerances for such breaches. They have also created limits with the dashboards to reflect if these tolerances are breached.

- Some firms are developing business-specific conduct MI, which requires specified action and escalation from the recipient.

- One firm took steps to develop metrics to measure a conduct risk as soon as the risk had been identified.

- Others would review metrics after a conduct incident occurred to see if changes were needed to ensure they would pick up such an event if it were to happen again.

- In general, firms said they have more work to do on conduct risk metrics. Over time, employee behaviour is likely to change as staff better understand what is being measured. Unless metrics continue to evolve as conduct risks and employee behaviour changes, there is a risk firms may take false comfort from their metrics.

- Firms are also focusing on how to develop metrics tailored to the outcomes they want to achieve.

We agree with firms that management information is an area that requires continuing attention.

Governance:

- Some firms have introduced a new or stronger conduct risk challenge in their existing New Product Approval or New Business Approval processes, and Reputational Risk Committees.

- Some also use post-deal analysis involving client input to gauge deal-specific firm integrity and conduct performance.

- A number of firms made considerable efforts to create governance and oversight structures for conduct in ways that might only have been applied to other risks in the past. For example, some firms have created specific committees to focus on conduct risk.

- Some firms include conduct and culture questions in staff and client satisfaction surveys to check how much they value integrity and reputation, and how this influences their choices.

Risk Appetite:

- Some firms have begun setting risk appetites for conduct risk and some have put tolerances and usages against their risk appetites.

- We recognise that setting a risk appetite for conduct risk may be harder than for prudential risk, and some firms said they had zero tolerance for conduct risk.

- We understand that firms do not want conduct issues and will try to decrease their conduct risk. However, we question if it is possible to move risk appetites to zero, given the range of business that firms undertake and the nature of conduct risk.

- The area of risk appetite for conduct risk is one we will continue to discuss with firms.

Training:

Firms increasingly recognise that identifying conduct risk is a skill in itself. So this section covers both training on risk identification and conduct risk training more broadly.

- Some firms have established highly visible programmes for conduct risk training that use small group sessions, often led or assisted by experienced business practitioners who draw on personal experiences. This approach was considered to be far more effective by firms who held these sessions than e-training (which in some cases can be quickly 'clicked through').

- Some firms have also launched more leadership/manager-specific training focused on the firm's business, conduct and culture.
- Some firms developed ethical decision-making training to help staff identify the right thing to do and how to make decisions in grey areas.
- Some firms developed advertising campaigns that connect everyday morality to their day jobs.
- Some firms have a decision-making tool to help staff make responsible and ethically sound decisions. The tool asks employees to consider their actions through a number of lenses before proceeding.
- Firms highlighted the benefit of using their own past conduct issues and case studies, where confidentiality allows.
- Some firms test their staff on their knowledge of procedures and discuss conduct scenarios in meetings.
- One firm has a rolling programme of supervisor reviews. These ensure supervisors meet the required standards and also identify any extra support they need to better detect poor behavior in staff they oversee.
- One firm is considering requiring individuals to pass an internal exam covering various topics, including conduct, tailored for the different functional lines. The firm believed that this may help ensure that bad conduct is not 'imported into the firm' by new starters and that new staff are clear about what is and isn't acceptable in the new firm.
- Some firms also held 'skip level' sessions. These allow senior managers to talk directly with junior staff and fast track firm-wide awareness of their programmes.
- Other firms use 'Integrity Training' with the firm's own case study examples, and behavioural psychology examples such as positive/negative framing techniques.

Recruitment

- Some firms consider conduct and culture at the recruitment stage, for example using situational judgment tests or looking to assess a candidate against the firm's values.

Escalation

- Some firms have been highlighting and sharing positive examples of where people have escalated issues and concerns, and also the consequences of non-escalation.
- Other firms have had senior people talking about mistakes they have made through their career to highlight that it's human to make mistakes and to encourage their escalation.

- One firm developed and trained their staff in an escalation framework and then used a fake internal 'rogue trade' to test the escalation procedures. At each stage when the trade was escalated and a decision made they would tell staff, in confidence, that this was a test and ask them to escalate the trade to the next level. This test was then written up and communicated to staff to reinforce the message that risk identification and escalation is both a structured process and a necessary daily occurrence.

- One firm introduced a new escalation channel specifically for conduct risk issues and sought to provide maximum assurance about preserving anonymity.

Question 4:
‘How does the Board and ExCo (or appropriate senior management) gain oversight of the conduct of business within their organisation and equally importantly, how does the Board or ExCo consider the conduct implications of the strategic decisions that they make?’

While Question 2 focuses on actions that firms take to encourage staff responsibility for managing conduct, certain Board and ExCo members will also have specific individual responsibilities under the Senior Managers Regime.

Findings:
Oversight of Conduct

- Many firms explained that they have a Conduct and Culture Report as a standing agenda item for their Board or ExCo meetings. This may include reports of conduct incidents, strategic decisions that may cause increased conduct risk, an assessment of new and emerging conduct risks and conduct risk metrics for all businesses and functions.

- Board and ExCo members may also sit on (Conduct) Risk Committees, which may meet more frequently than the Board, to ensure that conduct and culture programmes are rolled out effectively.

- Some firms are carrying out external client surveys to highlight any potential conduct and culture issues.

- Many firms run internal surveys and some now ask conduct-related questions. One firm asks staff whether they have anyone they can confide in at work, as they felt this was an essential need for everyone.

- Some Boards and ExCos require the internal audit function to routinely consider conduct and culture in business area audits. Internal audit sometimes undertake a stand-alone audit of the firm’s conduct and culture programme.

Strategy Setting

- Some firms think broadly about conduct risks when considering exiting from a business. One firm recognised that exiting a business in line with the contractual notice period could cause customer harm. The firm gave customers what they believed was reasonable notice (much longer than the contract terms) and made provision for a different supplier to take on the business if the customer wanted. The firm then worked proactively with the customers to move them to a new provider.

- One firm identified that their initial target for the year was overly ambitious and they were concerned that staff may be pressured into meeting it. They revised the target and clearly communicated to staff that they did not expect them to meet the initial budget.
- One firm, when making a significant strategic change to the business, deliberately decided to downsize the front office before the control functions to ensure appropriate oversight during the process.

Question 5:
'Has the firm assessed whether there are any other activities that it undertakes that could undermine strategies put in place to improve conduct?'

Many firms have focused this question solely on appraisals, remuneration and promotion. However, we view it as being very much wider, including horizon-scanning internally and externally and consider the root causes of live or potential conduct events.

Findings:
Appraisal, remuneration and promotion-related examples

- All the firms we conducted ACMs with consider both financial and non-financial factors for setting variable remuneration.
- Many firms link their own values and standards to the objective setting, appraisal and promotion process.
- In many firms, promotion now includes a much more explicit assessment of the individual's conduct and cultural characteristics and firms are making a real effort to explain this to staff.
- Firms are also increasingly making transparent (where they can) examples of where staff have been held back from promotion for conduct issues.
- Firms are increasingly splitting their grading system into 'what' and 'how'. Many are being explicit and transparent to staff that their performance grade and reward reflects not only the financial and non-financial performance achieved but also their conduct.
- At some firms, senior managers review a sample of appraisals and objectives to quality assure the system.
- Firms are generally gathering feedback from control functions as well as 360° feedback on people's conduct and behaviour, which is used in the remuneration and promotion process, particularly for more senior and risk-taking staff. Where this feedback reduces remuneration or stops a promotion, firms have highlighted the benefit in communicating this feedback to staff. One firm highlighted that some staff members go on to act on this feedback and become role models.
- Firms take different views about whether they should positively reward staff for excellent conduct and culture:
  - Some hold the view that it is 'expected' and apply penalties where staff fall short of the expected standards but do not reward it when it happens.

  - Others believe staff should be positively rewarded for excellent conduct and we saw a range of methods to do this. These included public acknowledgement, a financial reward (from the token to the more substantial) or a 'thank you' dinner with senior management, allowing for networking and a career development opportunity. Some firms specifically carve out part of their annual bonus pool to reward staff who have shown exemplary conduct and culture.

- When assessing conduct risk, a number of firms have developed or introduced 'scorecards' of linked metrics. These include those linked to promoting the firm's desired culture, strategy, values, reputation, quality of client relationships, stakeholder engagement and people. These firms believed this approach meant they were more able to measure performance against conduct objectives, and reward and incentivise incremental improvements in behaviours and conduct.

Wider analysis

Only a few firms had thought more broadly about Question 5 but we would encourage all firms to do this in the future.

Firms that had performed wider analysis had considered matters such as:

- Imposing challenging performance criteria and pressure to perform without adequate support or resources could lead to enhanced conduct-related risks.
- The execution risks generated by their own restructuring programmes and the risks these may pose to their conduct programmes.
- The risk of a lack of investment in conduct and controls programmes.
- The elevated staff-related risks in businesses that are being down-sized or exited.
- The risks posed by the behaviours of some clients and counterparties.
- Where the firm's own controls do not support the behaviour they want. For example, one firm identified it could improve personal account policy compliance by changing the process so the designated brokers provided trade confirmations directly to the Compliance function.

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